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Forcing Financial Institution Change Through Credible Recovery/Resolution Plans:
An Alternative to Plan-Now/Implement-Later Living Wills

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Summary: Many policymakers and analysts call for financial institutions to prepare a "living will." Observers hope the wills capture the advance planning needed for orderly resolution without bailouts. This is wishful thinking unless recovery and resolution planning (1) leads to changes to financial institutions and supervision in the here and now; (2) is driven by supervisors, not firms; and (3) has transparent outcomes.

Governments were not prepared for the potential failure of systemically important financial institutions (SIFI). SIFI failures and near deaths threatened to spill over to other financial firms, markets and the economy at large. Governments bailed out SIFI creditors to quash these spillovers. Creditors anticipating future bailouts will not check the risk-taking of SIFIs. Too much risk-taking by SIFIs means we will face another financial crisis absent effective reform.

In response, policymakers and analysts have called for "living wills" for financial institutions.[2] A living will for humans stipulates in advance the medical steps a terminally ill patient wants. A living will for financial institutions, under many popular conceptions, stipulates in advance the steps government and firms will take to produce an orderly resolution at a fatally weak financial institution.[3] Orderly resolutions obviate the need for bailouts. Living wills seem responsive to the prior lack of preparedness.

Unfortunately, such planning-focused living wills are not credible and will not prevent spillovers.[4] First, absent countervailing forces, SIFIs have organized themselves and operate in ways that produce spillovers and bailouts. Neither firm nor government can fix those problems at the last minute. Second, under the living will analogy, the firm draws up the living will. SIFIs have no incentive to draw up credible plans. Finally, creditors will not view living wills drawn up in private as real threats to future bailouts. Thus, creditor discipline will remain too weak.

Resolution plans with the following three attributes offer a more credible tool to reduce expectations of government bailouts. The plans should do the following:

1. Force changes to firm structure and operation and supervisory powers long before firms become financially weak (as some observers have also noted)[5];
2. Be prepared by supervisors based on firm input; and
3. Allow for transparency of plan-induced changes to outsiders.

Such resolution plans also offer important advantages over alternative reforms such as banning certain activities from banking organizations or breaking up SIFIs. And there is some evidence that credible resolution planning can make the fallout from financial crises less severe.

Before I discuss attributes of credible resolution planning, I will briefly describe living will reforms more generally.

The Gist of Living Wills

There is no shared understanding for what precisely constitutes a living will, hence, the multitude of names.

In general, proponents view the wills as tools to facilitate resolutions during grave times with minimal spillovers to the economy. Many versions of living wills would contain information such as the following:

- Catalogs and/or lists of key information needed during a crisis (e.g., lists of assets, lists of subsidiaries and their locations, summaries of key laws governing financial institution failure);
- Responses to "what if" scenarios (e.g., how would the financial institution raise more capital or liquidity, including from the sale of assets?); and
- Assessments on the state of firm readiness (e.g., capabilities of management information systems, "scores" assessing the ability of the plan to facilitate recovery/resolution).

Living will proposals may require parallel efforts by both the financial institution and the regulator/supervisor. The government agent would also have to consider their capabilities (e.g., legal, personnel, access to financial resources) to facilitate an orderly recovery or wind-down of the firm.

I now turn to the three attributes I think resolution plans must have to prove credible. The absence of such traits makes many living will proposals ineffective.

Ex Ante Change

The decisions that put financial institutions at risk for failure often occur over many years. In contrast, the firm can fall into unexpected, even fatal, financial distress in a very short period of time. Rapid decline makes it impossible for the financial institution to execute unplanned, significant actions to save itself. A financial institution that does not have effective databases to value and account for its assets cannot build such systems quickly. Likewise, firms cannot rapidly undo practices embedded in the firm's structure or operations that hinder recovery or resolution. How quickly can a firm untangle thousands of interconnected subsidiaries used to own, fund and manage assets?

Supervisors, for their part, cannot suddenly acquire the legal powers or staff to facilitate an orderly resolution over a weekend.

To be credible, resolution plans must lead to changes in financial institutions' and supervisors' operations before a crisis hits. How might such a credible resolution plan process work?

Before a financial crisis, bank supervisors would identify those attributes of financial institution operations, structure and funding that curtail effective, bailout-free recovery or resolution. The recent crisis suggests several attributes of SIFI operations that may need ex ante changes, including but not limited to: (1) information systems that either do not adequately capture key information on assets or are not accessible by business lines in the firm, (2) legal structure and geographic scope of firm operations that make resolution difficult to implement, and (3) interfirm funding or hedging strategies that make it difficult to sell off valuable parts of the firm to facilitate recovery.

The identification would feed supervisory action plans for the firm. The plans would identify appropriate changes to scale and scope of the SIFI's activities. Focusing on ex ante change saves the public from outdated plans or government agencies consulting heretofore dormant thousand-page plans during a crisis.

Supervisory Preparation

Financial institutions do not have incentives to plan for their demise. In particular, financial institutions would not spend resources determining how their demise spills over to others, let alone take steps to limit such fallout. Such activities impose costs but no benefits to the owners and employees of the financial institutions.

Government agents should act on behalf of society as a whole and seek to account for the spillovers from financial institution failure.

The respective incentives of government agents and financial institutions suggest that government supervisors/regulators prepare the resolution plan. This role seems particularly sensible if the plans will lead to important changes in firm and supervisor operations.

Supervisory leadership in plan development does not exclude financial institutions from the process. Information provided by the financial institutions will prove the critical raw input for plan development. But supervisors must determine what information to gather and identify the implications from that information.

Transparency

Observers have raised doubts about the ability and desire of financial institution supervisors to act in the public interest. At a minimum, critics note that supervisors did not prevent the type of risk-taking that led to the financial crisis. Others have taken a more critical view, arguing that supervisors are "captured" by the financial institutions they supervise. Captured governments made matters worse by, for example, approving firm mergers that raised both the systemic risk and political power of financial institutions. These critics would not find resolution plans driven by supervisors a credible tool to address systemic risk.

The government should address such credibility concerns head on even if policymakers disagree with the underlying arguments. If creditors of financial institutions agree that resolution planning is not credible, they will not view the planning process as putting themselves at greater risk of loss. As a result, creditors will continue to expect bailouts and will underprice financial institution risk-taking. Society will have too much financial institution risk if the price is too cheap.

Requiring resolution plan transparency will make the plans credible to creditors, leading to better pricing of risk. What form should transparency take? Congress could require supervisors to report on changes required at specific financial institutions. Policymakers could also bring in experts outside the supervisory process to review resolution planning effectiveness. In a more comprehensive approach, Congress could require supervisors to identify changes they have mandated in financial institution organization, activity, operation or size to reduce systemic risk. I have previously called for a system of "macroprudential ratings" that would achieve this goal.[6]

Comparing Options to Credible Resolution Plans

I have emphasized using resolution plans to reduce systemic risk by changing financial institution and supervisory operations. Some argue that society could accomplish the same outcome by limiting or banning the involvement of financial institutions in activities or operations that pose too much systemic risk. "Breaking up" firms also would force significant change to firm operations. This rule-based approach seems to have the benefits of the resolution plan through a credible, more straightforward approach.

The resolution approach is superior, because it generates better information on precisely what activities and operations of financial institutions and supervisors need reform. Observers and supervisors have a general sense of the type and level of activity posing systemic risk. But there is not yet common agreement on the relative contribution of a given activity to systemic risk. Does the assumption of certain asset concentrations pose the largest contribution to systemic risk of a firm? Or is it participation in select securities transactions? Perhaps the manner in which a firm organizes itself internationally poses the largest contribution to systemic risk. A legislative rule may target activities that analysts ultimately conclude pose second-order systemic risk concerns. Incorrect targeting could have serious opportunity costs, as it encourages policymakers to "let down their guard." The resolution plan approach, in contrast, would rely on the acquisition of detailed private information on a firm-specific basis before identifying activity and size restrictions.

In addition, a rule-based approach often offers "one bite at the apple." Firms will find ways to comply with the rule while still posing the same amount of ex ante systemic risk. The resolution plan approach requires repeated interaction to respond. Finally, resolution planning has the advantage of testing the new resolution regimes that many hope will facilitate imposition of losses on creditors.

Would Resolution Planning Make A Difference?

Legislative proposals before Congress would require preparation of resolution plans for systemically important financial institutions. The proposals are fairly general and generally provide some discretion to the government entity that would implement the requirement. The Senate Banking Committee proposal does put explicit rules around using the plans to require divestiture.

I think legislators could make the plans a credible check against systemic risk by ensuring that they have the three attributes discussed above. I make that claim not just on the logic already articulated, but also on examples where government-forced changes to firms and markets have made resolution and recovery more orderly.

For example, in July 2008, the FDIC issued a final rule requiring the largest insured banks to take steps allowing the FDIC to differentiate between insured and uninsured deposits.[7] The FDIC argued that it could provide unnecessary insurance protection to uninsured creditors absent such changes. The banking industry largely opposed the rule. Some in the industry argued that changes to systems should only occur once a bank faced difficulty. Otherwise, the rule would require "unnecessary" changes in operations for healthy banks. The FDIC rejected this strategy recognizing that planning in advance a la living wills was insufficient. Action, even if costly, must occur before firms get into trouble.

Issues around legal structure, intercompany funding and hedging, information systems and legal powers of resolution raised concerns of spillovers for firms like AIG and Lehman Brothers.[8] The resolution planning I have advocated would take on such issues directly before a crisis. It seems reasonable to conjecture that such planning could have reduced the potential spillovers from the demise of these firms.

Forcing change for firms and supervisors will not be easy, particularly for financial institutions with operations and supervisors located around the globe. Absent resolution planning, however, it is not clear how hurdles to orderly recovery and resolution will be overcome. We must take steps in good times to reduce huge bailouts in bad.

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[1] The views expressed are the author's and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.

[2] The terminology for these plans varies as do the details of each of them, making it challenging to generalize. A nonexhaustive list of plans and names follows: Legislation passed by the Banking Committee in the U.S. Senate and the U.S. House of Representatives used the term "resolution plan." The Obama administration's "Financial Regulatory Reform" proposal used the term "rapid resolution plan." In his May 6, 2009, Senate Banking Committee testimony, Raghuram Rajan used the term "shelf bankruptcy plan." The Squam Lake Working Group on Financial Regulation calls them "living wills" in addition to "rapid resolution plans" in its October 2009 discussion. Richard Herring called them "wind down plans" in "Wind Down Plans as an Alternative to Bailouts," Pew Financial Reform Project Briefing Paper #15, March 2010. The Financial Services Authority termed them "recovery and resolution plans" in its October 2009 Turner Review Conference Discussion Paper. The Cross-Border Bank Resolution Group called them "contingency plans" in its 2009 report and recommendations to the Basel Committee on Banking Supervision. Anil Kayshap termed them "funeral plans" in his June 2009 *Financial Times* editorial.

[3] For example, John Taylor recently offered the following point in his multipronged proposal to modify bankruptcy proceedings for financial institutions: "Fourth, a wind-down plan, filed in advance by each financial firm with its regulator, would serve as a blueprint for the bankruptcy proceedings." See John B. Taylor, "How To Avoid A Bailout," *Wall Street Journal,* May 3, 2010.

[4] Questions about the effectiveness of living wills have been raised in the popular press. Consider the following observations, for example: "Some industry lobbyists have questioned whether funeral plans will work, arguing they will be out of date when problems erupt. An institution will be far more focused on salvaging itself than updating its death plan, they said. 'When the stuff is hitting the fan, do you really think anyone is going to be scrambling to update their funeral plans? Please', said one large bank lobbyist who spoke on condition of anonymity." See Stacy Kaper, "Resolution Deal Near, But How Effective Will It Be?" *American Banker,* March 22, 2010. A prominent economist raised similar concerns about effectiveness, although for different reasons: "How well [living wills] will work is hard to say. Like real wills, these financial wills may well be contested by next of kin when they are about to be applied." See Greg Mankiw's comments on Alan Greenspan's "The Crisis," March 19, 2010.

[5] Others have emphasized the need for resolution planning to produce action before a crisis. Examples include the following: Federal Reserve Board Governor Daniel Tarullo argued that effective resolution plans may lead to "very significant" upgrades to management information systems for firms. Tarullo noted that such ex ante changes would also encourage financial institutions to simplify their corporate structure, ex ante. See Governor Daniel K. Tarullo, "Supervising and Resolving Large Financial Institutions," November 10, 2009. Thomas Huertas also links resolution planning with contemporaneous changes to (1) SIFI operations and structure and (2) laws and financial infrastructure. He argues that such ex ante changes reduce the likelihood of bailouts. See Thomas F. Huertas, "Living Wills: How Can the Concept Be Implemented?" February 12, 2010. The Financial Stability Board also highlighted the potential for resolution planning to facilitate changes to SIFI organization. See Financial Stability Board, Report of the Financial Stability Board to G20 Finance Ministers and Governors, April 19, 2010, p. 10. Finally, Emilious Avgouleas et al. view resolution planning as a tool to modify firm operations and structure as well as the underlying legal regime on resolution. See Emilios Avgouleas et al., "Living Wills as a Catalyst for Action," 2010.

[6] See Gary H. Stern and Ron Feldman, "Macrostability Ratings: A Preliminary Proposal," *The Region,* Federal Reserve Bank of Minneapolis, September 2009.

[7] For a discussion of the FDIC's initial proposal, see Ron J. Feldman and Gary H. Stern, Managing TBTF by Reducing Systemic Risk: Some Recent Developments, *The Region*, June 2006. For the final rule, see Federal Register vol. 73, no. 138, July 17, 2008, pp. 41180-41211.

[8] For a discussion of Lehman Brothers and resolution planning, see Richard Herring and Jacopo Carmassi, "The Corporate Structure of International Financial Conglomerates" in Alan N. Berger et al., *The Oxford Handbook of Banking,* 2010, pp. 195-229.